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RIP IPP

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After only five years, the first stage of deregulation in Japan, the IPP era, is drawing to a close. Market analysts say that Japanese electric utilities (JEUs), who so far have signed contracts with about 40 IPPs, are increasingly unwilling to lock into long term power purchase agreements due to the continuing weakness in the Japanese economy which has forced the JEUs to postpone even their own power station projects.

A government review of energy deregulation is also on the horizon, the results of which are expected by 2003. ?The review may well consign the IPP model to the dustbin and instead foster the growth of a large merchant power sector,? says one electricity analyst. Several merchant power financing deals are already being discussed.

At least this first stage of deregulation is ending with a bang rather than a whimper. This year, one of the largest IPP financing transactions yet seen in Japan is expected to close, a deal for a 1,400MGW coal fired plant (comprising two separate 700MGW facilities) sponsored by Kobe Steel. The financing (reportedly limited recourse) is being arranged by IBJ, Sanwa, Sakura, DKB and Development Bank of Japan (DBJ), with Sanwa Bank also acting as financial adviser. ?The total size of the project is about $2 billion (assuming an exchange rate of ¥120 to $1.00),? says a banking source involved in the deal. Kansai Electric Power Company will be the project's off taker.

As Project Finance went to press, the arranging banks were on the verge of sending out commitment letters for the debt financing, which is understood to account for about three-quarters of the total project cost. According to the same banking source, the project company will be 100 % owned by Kobe Steel.

Unfortunately for the international banking community, although this is one of the largest IPP transactions to come out of Japan, it is understood that Kobe Steel wants to keep the financing local. The reason why gives a good clue about the true nature of the financing arrangement being drawn up: ?the company believes that it will be in a better position to negotiate with its bankers, in the event that the project takes a turn for the worse, if it continues to rely on relationship and domestic institutions,? says a second banking participant.

A further six or seven finance facilities are currently under negotiation for other IPP developments in Japan, says Toshihiro Toyoshima, deputy director in Development Bank of Japan's project finance department. However, not all of these facilities will be limited recourse.

A source at Sanwa says his bank will close several power sector transactions in 2001 in conjunction with other local banks. The banker declined to reveal who the sponsors of these projects are, or the size and location of the plants, but he says that several foreign companies will be involved. In addition, he believes that the market will be driven in the future as much by acquisition activity as by new greenfield or brownfield developments. Of the deals that Sanwa is currently involved in, there is at least one proposed acquisition financing.

However, although the bank is trying to arrange limited recourse finance facilities for the planned IPP schemes, the Sanwa executive says that corporate financings have not been ruled out. One foreign financier speculates that most of the Sanwa deals on the table will be corporate finance transactions. ?Many of the bank's traditional customers ? those who are most likely to be interested in power projects ? are not in such great financial shape and corporate facilities and extensive guarantees are likely to be necessary,? the foreign banker says.

Another IPP deal likely to close within 12 months is the financing of a 270MGW Off Gas power station for Toa Oil. According to parties close to the deal, the term sheet is currently under negotiation, with DKB acting as financial adviser to Toa. DBJ, so far, is the sole arranger, but this may change once preliminary negotiations have been concluded. Toa has requested a limited recourse deal but the two banks in the deal are still conducting their risk analysis and have not committed to a project financing. At the moment, Toa is the sole sponsor but bankers report that a second organization may join the deal (the second investor is believed to be a utility company), before the financing is launched.

Merchant power market

Toyoshima points out that a number of power plants in Japan are already operating on a merchant power basis. However, these plants are small-scale and almost all were previously captive generators, adapted for merchant power contracts during this current stage of market deregulatation. Since no greenfield power projects have yet been built with the intention of operating on a merchant power basis, there have been no merchant power station financings to date.

Watch this space, however. Toyoshima believes that the first merchant power station financing will happen in the next two years. His forecast seems well founded: another Japanese banker says, ?we are already involved in consultations for the financing of several merchant power plants. A lot of the local trading houses are interested in this market and want to finance projects on a limited recourse basis.?

What will appetite be like for merchant power risk amongst Japanese institutions? Given the fact that the Japanese economy appears to be locked into a prolonged period of slow growth, and that electricity demand growth is also anemic (more on that below) even those Japanese banks with strong links to Japanese trading houses are cautious about merchant power deals. ?I think most deals will have to feature some sort of minimal off take guarantee from trading companies, other sponsors or brokers as a result,? says the banking source.

Faced with Japanese sponsors' preference for tapping local funding sources, non-Japanese banks are still pessimistic about their chances of being involved in the Japanese power market, at least in the short term. But as DBJ's Toyoshima points out, the number of Japanese lenders is shrinking. Combined with the rise of more risky merchant project financings, Toyoshima says: ?the Japanese power sector may need foreign institutions to participate in project financings. Particularly at the syndication level.?

Foreign entrants

This is, of course, an untested hypothesis. The best chance for foreign banks to gain a foothold in the market remains via the activities of foreign power companies in Japan. But to guard against penetration by foreign competitors into their home base, Japanese banks are already linking up with international power companies for domestic developments. Like Sanwa Bank, Bank of Tokyo-Mitsubishi is working on several proposed power projects, some involving foreign investors, says Hideya Takaishi, chief manager of the infrastructure team. ?None of these deals are likely to close in 2001,? says Takaishi.

Worse, foreign power companies are hardly flooding into the Japanese energy market. ?Most international energy companies are still in the scoping phase,? says Peter Evans, a senior associate at US energy consultancy CERA. One of major deterrents for foreign companies is the difficulty of acquiring generating capacity. ?The greenfield option involves a very long time horizon,? explains Evans, ?and the other option, to enter the market through acquisitions is difficult since Japanese electricity utilities aren't being unbundled.?

Gaining a foothold in the market by building new generating capacity will be all the more unappealing when new entrants consider the demand and supply projections for the industry. Japans' existing utilities themselves are cutting back on new developments due to lack of demand. One equity analyst in Tokyo notes that Tokyo Electric Power (Tepco) will postpone the introduction of planned power facilities by three to five years in the face of slow growth in domestic power demand. The changes to Tepco's power supply plan are likely to mean the suspension of work at 12 power plants nationwide. The analyst also says that Tepco will reduce average annual capital investment to below ¥1 trillion from fiscal 2001 to fiscal 2003. By comparison, Tepco plans to spend ¥1.08 trillion for fiscal 2000 through to March 31 this year.

Two favourable scenarios could, however, materialize out of current market conditions, speculates Evans. Firstly, the consultant believes, with more indigenous power companies under financial duress (note that Standard & Poor's just recently cut its ratings on the three largest JEUs, Tokyo Electric Power, Chubu Electric Power and Kansai Electric Power from AA to AA-) local utilities may be willing or all but forced to sell off some generating assets. This assessment is in line with Sanwa's belief in an increasingly acquisitions driven market.

Secondly, a prolonged period of slow growth could precipitate a fall in the value of the Yen which in turn would make Japan's shrinking industrial base more cost competitive. Growth in the industrial base would spur both economic and electricity demand growth.

Although it is hard to second guess the Japanese government's intentions, Evans also believes that unbundling could be a core part of the next phase of liberalization.

At present the main reason that it is so difficult in Japan to divide electricity utilities into their constituent parts, in contrast to countries like the UK, is that they are private companies. The government cannot simply command the JEUs to sell-off assets, as happened in Britain where the electricity industry was stated owned. If the Japanese government decides that the energy industry needs to be made more competitive, it will therefore need to provide compelling incentives for unbundling.

Championing the unbundling of the JEUs will be an expensive political decision. But the fact that the head of Japan's electric industry spokesgroup recently stated his opposition in public to unbundling, citing California's energy problems as a possible result, is an indication of the way things are moving. Analysts suggest that the trade group would not have felt it necessary to voice open opposition to unbundling if momentum wasn't building for unbundling option.

Few foreign companies have expressed more commitment to the Japanese power market than Enron and it is apparently willing to consider large scale greenfield ventures. Through its joint-venture partnership with Orix and Orix USA, called Encom, Enron is considering building a substantial new power plant in the village of Rokkasho, Aomori Prefecture. The man heading up Enron's operations in Japan, Carey Sloan, says his company is looking at a combined cycle plant of at least 2000MW in Aomori, possibly more. Yet Sloan says that Encom has so far only committed to a feasibility study. After that, and a lengthy environmental impact study, and if all went to plan plant construction of a plant in Aomori might begin in 2004. Carey says that implies Encom would start to consider its non recourse or limited recourse financing alternatives in late 2002 and in 2003.

Market observers say that it has not yet been decide whether the prospective Rokkasho plant would operate as an IPP or a merchant facility and until that has been decided it will not be possible to talk about specific financing details.

Press reports that Encom plans another plant, this time in Fukuoka were not confirmed by Sloan. He does say, ?we have sent our scouts out all over the country and have identified six or seven sites where we think we have what we need to run a successful business. These are sites which could theoretically sustain plants with significant capacity, plants possibly as large as the proposed Aomori power station.?

One source says that Enron is already committed to at least one power project in Japan (beyond the feasibility study stage). The project is understood to be in Kyushu and is a joint venture with Mitsui Mining. However, rather than being a greenfield development, the project involves the rehabilitation of an existing plant, which has space for an additional generating unit to be built.

Not surprisingly, Enron is more up beat about Japan's electricity business than some of its competitors. ?Electricity demand growth is not completely flat,? says Sloan. ?We estimate that the market has been growing and will grow about 1.5 % to 2 % a year, even during a recession.? Sloan adds that additional demand growth, particularly in the form of summer peaks, is being caused by rising electricity requirements to power appliances like air conditioners. Extensive IT expenditure is also helping to sustain the growth. ?If ever the economy does recover will be expecting a lot more growth on top,? Sloan concludes.